

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:SER:SFL:MIA:TL-N-6434-99

DRSmith

date: December 6, 1999

to: Margaret Vincent, Revenue Agent, Exam Group 1157  
Fort Myers POD

from: District Counsel, South Florida District, Miami

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subject: [REDACTED]

Tax Years Ended [REDACTED] and [REDACTED]

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This memorandum responds to your request for advice dated October 22, 1999.

ISSUE

Whether you are correctly adjusting the taxpayer's calculations in utilizing the non-accrual experience adjustment provisions under I.R.C. § 448 and the applicable regulations?

## DISCUSSION

As a qualified personal service corporation in the health care industry, the taxpayer properly utilizes the special rule under I.R.C. § 448(d)(5) which permits non-accrual of any receivables which, on the basis of its experience, will not be collected. However, in using this method, the taxpayer must follow the guidelines set forth in Treas. Regs. § 1.448-2T(e)(3). The regulations provide that, in computing gross income from accounts receivable, the taxpayer shall include the amount that would ordinarily be recognized as gross income, less the amount which is not expected to be collected. In this case, the taxpayer does not expect to collect amounts identified as "contractual adjustments", which are downward adjustments to medical charges made as a result of the taxpayer's contracts with health insurance carriers, Medicare, Medicaid, etc. Due to what you perceive as the taxpayer's incorrect computation of its non-accrual experience adjustments in utilizing this formula, you have proposed audit disallowances of \$ [REDACTED] and \$ [REDACTED] for the taxable years ended [REDACTED] and [REDACTED], respectively.

Your memorandum indicated that the taxpayer, in its calculations, has used a "gross bad debts" figure which did not include actual recoveries of bad debts made in each year. We agree with you that, to the extent that these amounts were not included in gross income, they must be added back to gross income. Treas. Regs. § 1.448-2T(e)(3) expressly states that upon collection of such an account receivable, additional gross income shall be recognized with respect to the collection of any amount not initially expected to be collected (see also Example 3 under this regulation). The validity of this regulation, as well as the mechanical application set forth therein, was upheld in Hospital Corp. of America, 107 T.C. 116 (1996).

You indicated that, in its calculation of non-accrual experience adjustments, the taxpayer did not adjust its "gross revenue" column for amounts such as contractual adjustments which, based on its experience, it knew would not be collected. Again, we agree with your position that this is incorrect, since it will result in overstating the bottom-line non-accrual experience adjustment.

You also indicated that, in making these calculations, the taxpayer is not removing the amount of the contractual adjustments from its year-end gross accounts receivable figures. Again, we agree with your reasoning. The taxpayer's method will result in an erroneous calculation, since those amounts were never included in gross income and thus should not be included in computing year-end receivables.

We hope this answers your questions. If any further assistance is needed, please contact the undersigned at (305) 982-5333.

David R. Smith

DAVID R. SMITH  
District Counsel

✓ cc: Assistant Chief Counsel (Field Service)